

What is the state budget outlook?



INTRODUCTION

After facing a period of severe revenue shortfalls, Montana has seen a dramatic turnaround in some key revenue sources. Revenues from individual income, corporate income, and oil and gas production taxes have increased significantly in FY 2004, FY 2005, and FY 2006. The legislature entered the 2007 session with a large projected fund balance as of the end of FY 2009. But the fund balance was not necessarily available for any purpose, as a significant portion was from nonrecurring revenue. There were also tenuous assumptions for the capital gains component of individual income tax, the sustainability of corporate profits, and the future of oil and gas price and production. This means there was risk in using these revenues for ongoing programs or services, which could create a fiscal crisis in subsequent biennia. In what is always a challenging fiscal environment, the 60th Legislature was faced with an opportunity to shape a budget that addressed some of the state's ongoing fiscal issues while at the same time taking on some very daunting fiscal challenges, including unfunded liabilities in state retirement systems, population growth in corrections, school funding, healthcare issues, and a significant building maintenance backlog.

In this chapter, we “set the stage” for the discussions to follow in this report. It includes a state economic overview, and how those economic conditions affect the state fiscal outlook, state revenues, and the general fund budget in particular. We then summarize the major fiscal challenges this legislature faced, the legislative response/solutions to the challenges, as well as continuing issues regarding those challenges/solutions.

In a nutshell, this section provides summary answers to the following questions:

- What is the current economic profile of Montana?
- What is the state's fiscal condition?
- What were the major fiscal challenges facing the 2007 Legislature?
 - What are the legislative solutions to the major challenges?
 - What are the significant issues that still remain related to these challenges?

The majority of the issues discussed in this overview are discussed in more detail in the remaining chapters.

What is the current economic profile of Montana?



ECONOMIC OVERVIEW

Montana state government, like any other business, is influenced by economic and demographic developments. For example, Montana's economic base as well as the strength of the U.S. economy determines the level of revenues collected from individual and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic conditions affect state government disbursements for education, human services, public safety, and other governmental services.

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since individual income tax is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Federal revenue correspondingly is used to fund a number of human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

Conversely, Montana's total expenditure base is targeted toward educational and human service programs, with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, this usually translates to an increase in population or a reduction in unemployment levels. With population increases comes a corresponding increase in educational and human service costs. A greater population requires a better transportation system, not only for the general populace, but also for the businesses that expect to expand to meet the needs of an ever-growing population.

Montana's economy is highly dependent on agriculture, tourism, natural resource extraction, and mining. All of these industries produce residual wholesale/retail trade and service sector jobs. If the basic industries are not flourishing, other sectors suffer as well. And if Montana's economy slows, tax revenue growth usually follows the trend because of the state's dependence on individual income tax revenues.

In some instances, economic strength can be a "good news / bad news" dilemma. For example, if total personal income increases significantly, this usually translates into higher individual income taxes. On the disbursement side, however, strong personal income growth can result in increased state general fund match amounts for the federal Medicaid program. If Montana's total personal income growth is unusually high when compared to the national average, the federal medical assistance percentage (FMAP) rate declines, thereby requiring the state's general fund matching rate to increase. This situation is expected to occur during the 2009 biennium.

Employment and wage indicators continue to support stronger growth in the near-term, with the prospect of more moderate growth from calendar 2007 to 2009. While capital gains income rebounded in calendar 2004 and 2005, net capital gain realizations are expected to remain stable during calendar 2007, 2008, and 2009.

During calendar 2001, the Federal Reserve Board (FED) reduced interest rates 12 times in an attempt to stimulate the US economy. As the economy began to regain strength in calendar 2004, the FED began increasing rates to insure stable growth with the goal of maintaining low inflation. Most economists project interest rates to stabilize during the 2009 biennium at close to historical averages. Short-term rates are expected to be about 4.5 percent, while long-term rates are expected to be close to 5.5 percent. The effects of higher interest rates may have some dampening impacts on economic growth to the benefit of increased state revenues from investments.

Even though interest rates have increased from historic lows, corporate profits are expected to increase significantly during calendar 2006 and increase only modestly thereafter. Property values continued an upward trend in 2006, and that trend is expected to continue through the 2009 biennium. Net taxable value growth in tax year 2006 (FY 2007), however, is expected to be near 5.7 percent as business equipment property growth is expected to be unusually high.

After decades of reductions in oil production – from a peak in 1973 of 34 million barrels to a trough in 1999 of 15 million barrels – recent Montana production has increased. With higher prices, new drilling activity increased 75 percent in 2003, and has increased nearly the same amount in 2004. In calendar 2005, production was over 32 million barrels and will probably be near 35 million barrels in calendar 2006. Higher production is expected to continue through calendar 2007 and then begin to decline in subsequent years.

Natural gas production in Montana doubled between 1981 and 2003 due to higher market prices, from 40 million cubic feet (MCF) to 80 million MCF, with 75 percent of that increase since 1997. Newly drilled wells have contributed about 20 percent to total production since calendar 2000. As with the oil market, new drilling activity was up substantially in calendar 2003 and 2004. Higher production is expected to continue through calendar 2007 and then begin to decline in subsequent years.

In summary, the economic outlook for the state is for strong to moderate growth throughout the forecast period. This general outlook for Montana's economy is supported by testimony received on November 15, 2006. The Revenue and Transportation Interim Committee set aside part of a scheduled meeting to hear from Dr. Paul Polzin, Bureau of Business and Economic Research. Dr. Polzin provided the committee with his positive outlook on various aspects of the state and national economies.



STATE FISCAL PICTURE

INTRODUCTION/SCOPE

The previous section described the economic outlook for Montana from the perspective of how economic activity at the state, national, and world level impacts state revenues and disbursements. This section describes in more detail how those economic conditions affect the state fiscal outlook and ultimately the size of the 2009 biennium budget.

GENERAL FUND REVENUE IMPLICATIONS

Montana's fiscal outlook for revenue growth is expected to be healthy but not nearly at the level observed during fiscal years 2004, 2005, and 2006. The revenue estimates adopted by the Revenue and Transportation Interim Committee (RTIC) shown in the revenue estimating resolution (HJ2) are based on strong economic growth through calendar 2006 with more moderate growth for calendar 2007, 2008, and 2009. Figure 1 shows the comparative change by major revenue category, for an average increase of 5.9 percent over the 2007 biennium. For a complete discussion of general fund revenue forecasts by category, see the detailed explanation for each revenue component in [Volume 2 - Revenue Estimates](#).

The key economic assumptions targeted as most affecting state government receipts are Montana total income (all sources reported as individual income tax income), employment and population levels, inflation rates, corporate profits, property values, interest rates, and energy prices. As discussed in the previous section, "Economic Overview", the outlook for the majority of these targeted assumptions is positive for Montana's economy. The impacts of the current economic situation are reflected in the assumptions that were used to derive the revenue estimates and key factors are briefly highlighted below. A detailed explanation for each revenue component is in [Volume 2 - Revenue Estimates](#).

- Wage and salary income provides the largest portion of total income reported on state tax returns. On average, wage and salary income contributes about 65 percent of total income. Average growth has been 5.7 percent from calendar 1990 to 2005. For calendar 2007, growth is expected to be 9.5 percent, declining to 4.9 percent in calendar 2008, 4.0 percent in 2008, and 4.3 percent in 2009.
- Capital gains income increased sharply in relative to proportion of total income during the 1990s, growing from 4.2 percent to 9.2 percent of total income. Because of "9/11" and the effects of an economic recession, capital gains income plummeted during calendar 2001, 2002,

Figure 1 General Fund Revenue By Major Category			
Major Category	2007 Biennium	2009 Biennium	Percent Change
	Estimate Millions	Estimate Millions	
Individual Income Tax	1,562.769	1,650.704	5.63%
Corporation Income Tax	314.732	328.335	4.32%
Vehicle Tax	230.378	240.107	4.22%
Investment Earnings	107.178	102.446	-4.42%
Natural Resource Taxes	214.289	240.316	12.15%
Property Tax & Non Levy	369.723	404.976	9.53%
Insurance Tax	119.036	126.183	6.00%
Consumption Tax	263.003	281.330	6.97%
All Other Revenue	295.713	306.986	3.81%
Total General Fund	3,476.823	3,681.383	5.88%

and 2003. By calendar 2004, capital gains income began a rebound but is projected to remain stable at calendar 2005 levels through calendar 2009.

- Average annual growth in employment between 1990 and 2005 has been 2.4 percent, although since 2000 the average rate of growth has been 1.7 percent. It is expected that employment growth through 2006 will be 2.0 percent and decline to 1.6 percent in calendar 2006. Growth is expected to slow further in 2008 and 2009 to 1.4 and 1.2 percent, respectively.
- Population growth since the early 1990s has been positive, varying between 0.1 percent in 1998 to 2.3 percent in 2000. Growth through the next biennium is estimated at 0.7 percent annually. Population growth has an impact on revenues from consumption and individual income taxes.
- Since 1990, inflation has averaged 2.7 percent annually and is estimated at 2.3 percent through calendar 2009.
- Between 1990 and 1997, U.S. corporation tax profits increased an average 10.3 percent per year, but have decreased an average 3.0 percent annually from 1997 through 2001, the greatest decrease of -8.5 percent occurring in 2001. In 2004 and 2005, corporate profitability increased by 26.0 percent and 32.7 percent respectively. That trend is not expected to continue, with projected annual increases of approximately 1.7 percent between 2007 and 2009.
- Property tax values increased slowly in the 1990s but fell in fiscal 2000 and 2001, primarily due to legislative changes that reduced the tax rate for business equipment property. Property values resumed an upward trend in 2002 and have increased every year since that time. That trend is expected to continue through the next biennium with an average annual growth of about 3.9 percent.
- Interest rates declined dramatically beginning in January 2001 to an unprecedented low in 2004. However, as the economy started to regain strength in 2004, and the Federal Reserve began increasing the discount rate. Short-term interest rates are expected to remain stable during the 2009 biennium. Long-term rates are expected to increase slightly through the 2009 biennium.
- As discussed in the previous section, high energy prices, especially for oil and natural gas, are expected to result in substantially increased production levels from these commodities in Montana. Oil production was over 32 million barrels in 2005, and is expected to be near 35 million barrels in 2006. Production is expected to peak in 2007, just over 38 million barrels and then decline to 36 million and 32 million barrels in calendar 2008 and 2009, respectively. Natural gas production was 80 million cubic feet (MCF) in 2003, and is expected to be 107 million MCF in 2006, 107 million MCF in 2007, 104 million MCF in 2008, and 100 million in calendar 2009.

GENERAL FUND DISBURSEMENT IMPLICATIONS

Montana's disbursement growth, like revenue growth, is responsive to economic and demographic conditions. While income levels, commodity prices, and interest rates influence revenue collections significantly, disbursement levels are more susceptible to population trends and demographic characteristics. Inflation rates also impact disbursement amounts, but are not a good overall measure of disbursement trends.

As happens to every consumer, the price government pays for goods and services increases because of price adjustments. Although state government does not purchase the same mix of goods that consumers do, the price of the goods they do purchase will increase in response to adjustments for inflation. Correctional services are a good example of a state operation that experiences high inflationary impacts relative to food and medical service purchases.

Over 20 percent of general fund expenditures are labor costs. Historically, the legislature has attempted to adjust employee compensation upward by an amount that recognizes the effect inflation has on an employee's take-home pay. The adopted legislative budget increases employee pay by 3 percent each year of the biennium to compensate for these inflationary impacts.

Finally, over 60 percent of general fund expenditures are educational support costs and direct human service benefits. For both of these types of services, inflationary increases can be substantial. Educational costs are directly tied to an increase in employee compensation, while human service benefits are heavily influenced by the cost of medical services.

As discussed previously, total population growth trends have been somewhat erratic varying from almost no growth to over 2 percent in 2000, with growth rates expected to be about 0.7 percent per year throughout the next biennium. Even at this modest rate, the demand for state services continues to increase. Depending on the demographics (age, income, etc.) of the population base, the demands for government services are a direct result of increased school enrollments, human service caseloads, and government employee workloads. With a shift in average age, school populations have declined while human services and corrections populations have grown. "Baby boomers" will continue to place increased pressures on government social programs as they enter retirement age.

The adopted legislative budget reflects a steep demand for government services due to a myriad of reasons (see page 61). The legislature increased general fund appropriations by \$380 million over the FY 2006 biennium base just to continue existing state services. Significant increases are targeted to human service, education, and public safety services, which represent nearly 78 percent of all general fund spending. In total, the legislative budget adopted in HB2 (including pay plan and retirement adjustments) is an increase in general fund authority over the FY 2006 biennium base of \$651 million (24.9 percent).

GENERAL FUND ECONOMIC IMPLICATIONS – SUMMARY

In summary, revenue growth is expected to be moderate through the 2009 biennium, and when coupled with a large beginning general fund balance, the 2007 Legislature faced an unprecedented fund balance as it began to prioritize state spending. Montana experienced the economic recession of the early 2000s but not nearly as severely as the rest of the nation. Although state revenues dropped off sharply during this time, revenue collections recovered in FY 2004, FY 2005, and FY 2006.

The cost of governmental services will continue to increase, even with a moderate rate of inflation and a slow growth rate in total population. School enrollments are declining, yet costs to support public schools continue to increase, especially in view of the recent court decision that determined that schools were under-funded. Human services costs will continue to escalate because of greater caseload demands, higher medical costs, and an increase in the state Medicaid match rate resulting from improved per capita incomes. Corrections population growth projections will also add to significant expenditure growth pressures.

While the 60th Legislature faced a bright financial picture, there were significant challenges and issues that needed to be addressed. Unfunded retirement liabilities, school funding, health care costs, maintenance of state facilities, and correctional system populations are just a few of the major issues that were addressed. Furthermore, there is always uncertainty surrounding the price of oil and the impact the natural resource industry has on the economy in Montana. A sharp drop in the price of oil could significantly reduce revenues from oil production taxes, corporation income taxes, and individual income taxes.

What were the major fiscal challenges facing the 2009 legislature?
What actions did the legislature take to address the challenges?
What are the significant issues that remain in the wake of this session?



MAJOR FISCAL CHALLENGES AND SOLUTIONS

The *Legislative Budget Analysis 2009 Biennium*, released in January 2007, identified a number of major fiscal challenges that the 60th Legislature would face when it convened. These ranged from the level of public school funding required to estimating the health care needs of the state to funding a growing corrections population and caseload to meeting the ongoing costs of state workforce and infrastructure. These challenges are complicated by another dimension of challenges related to the sustainability of state revenues and ensuring that state government lives within its means.

A sizable available balance was and still is anticipated for the end of the 2007 biennium, and strong collections are anticipated through the 2009 biennium, which would imply that that meeting the fiscal challenges would not be a daunting task. However, in the end, it seems that the sizable balance was possibly the greatest challenge of them all...how the legislature would piece together a balanced budget that serves the needs of the citizens of Montana, is sustainable, and at the same time providing meaningful tax relief to taxpayers. When all was said and done, at the conclusion of the 90-day regular session and a 5-day special session, few legislators seemed pleased with the final product but the collective body had taken actions that met, at least in part, many of the challenges outlined before the session.

What remains to be determined are the answers to those questions and concerns about the sustainability of the recent growth in revenues. Of the revenue received in the recent two years and anticipated in the next two years, how much can be considered ongoing in nature and how much will be determined to be one-time revenues that cannot be counted on in the future years. And what does the future hold for Montana economic growth and stability?

To provide some perspective on the outcomes of the 2007 legislative session and subsequent special session, the following restates the challenges identified before the session, followed by a description of relevant actions of the legislature and remaining fiscal issues identified by the legislative fiscal staff.

Fiscal Challenge

Funding for schools remains a significant fiscal challenge in spite of the work done during the interim by the Quality Schools Interim Committee and the funding provided in the December 2005 Special Session. These activities and actions were a response to a district court decision in April 2004 (upheld by the Montana Supreme Court in November 2004) finding that state funding for K-12 education is not adequate and that the current funding methodology is unconstitutional. The coalition that brought the suit commissioned a study to again determine whether funding is adequate. The results of the study were expected by the beginning of the 2007 session which could result in pressure for more school funding over and above inflationary increases. In addition, although school enrollment has been declining for several years, there is evidence that the trend is reversing as projections show slight increases at the elementary level beginning in the current year and the number of births has been increasing for the past 5 years.

Legislative Action: In the 2007 special session the legislature increased state support for K-12 by \$107.4 million in the 2009 biennium, which represents a 9.4 percent biennium to biennium increase. The new money is for full-time kindergarten as well as other initiatives. Not counted in this is new money for inflation (\$42 million) and continuation of the December 2005 special session payments of \$71 million (in the December 2005 special session, the legislature provided \$35 million in ongoing state support for FY 2007, as well as \$32 million in one-time only support). The 2007 Legislature also approved new state appropriations that do not represent new money to school districts. These include \$21 million in property tax relief and \$41 million in savings for a new school facilities trust.

Issue: The most recent research regarding the adequacy of Montana's K-12 funding system was delivered in a paper by Augenblick, Palaich and Associates in January 2007. The study said that in order for Montana to meet the requirements of the federal No Child Left Behind Act by 2014, overall funding for Montana's K-12 system must increase by \$325 million per year, phased in over 7 years. Requiring that the K-12 system spend \$325 million more per year in seven years will be a challenge. This is an increase of 25 percent over current spending, or 3.5 percent per year. This is challenging but unreachable. However the study was unclear whether this number was in 2014 dollars or 2007 dollars. If it is in 2007 dollars, the inflated increase in 2014 would be close to 400 million per year, or an increase of 31 percent over 7 years. The study also gave no prescription regarding the state share and the local share for the required increase in spending. Please note that other studies conducted earlier in the interim varied significantly in their conclusions about funding adequacy.

It is unknown whether the plaintiff's in the 2004 adequacy lawsuit will ask the district court for a show cause hearing. Such a request would signal that the plaintiff's are not satisfied with the amount of funding supplied by the legislature in FY 2007 and the 2009 biennium.

Fiscal Challenge

Health care costs make up a large share of total state and local government expenditures. A 2005 report by the Milbank Memorial Fund and the National Association of State Budget Officers showed that Montana state government health care expenditures for FY 2003 were nearly 26 percent of total state expenditures (all funds). Besides the obvious spending categories of Medicaid and CHIP, health care costs are a component of state employee costs, corrections costs, and higher education costs, as well as distributions to local governments and schools. With growth of medical and prescription drug costs well ahead of normal inflation, there is no relief in sight. This trend is accompanied by other variables: 1) a growing number of uninsured, and 2) increased complexity in the way health care is provided due to advances in treatment, including advances in technology, that make it possible to treat patients that may not have had treatment options before. Growing state costs are fueled to some degree by an aging population with growing demands for services and reductions in the federal Medicaid rate. Underestimating costs could result in a budget-breaking supplemental request or further reductions in health care services.

Health care costs are an important part of the dynamic. The legislature also considers programs to ensure that people have access to health care. If persons do not have insurance or the financial means to pay for health care, they may delay treatment when it sometimes costs more to treat a condition in its later stages. If medical bills go unpaid, it results in a cost shift to other payers, including public programs.

Legislative Action: The 2007 Legislature expanded support for health care services. Health care services provided through Medicaid account for \$1.8 billion or almost 23 percent of the total 2009 legislative appropriations. The legislative budget provides a number of increases in Medicaid including: \$117.5 million in service utilization; \$41.2 million in service and eligibility expansions; \$78.7 million in provider and direct care worker wage increases and \$89.9 million in hospital utilization fees to ensure availability of services; and \$21.6 million in increased general fund support to offset declines in federal funds. Other legislative health care services expansions include \$18.8 million total funds for community mental health services and prevention programs, \$9.6 million in state special revenue to provide health insurance to uninsured, \$5.4 million state special revenue for chronic disease prevention programs, and \$8.2 million to expand eligibility for the Children's Health Insurance Program (CHIP).

HB 13, the state pay plan bill, appropriated \$13.5 million over the biennium for increases in the monthly employer contribution to state employee insurance, raising the total employer contribution to \$626 in 2009. The legislature also appropriated \$1.3 million general fund for start up costs for community health centers.

Issue: The challenges surrounding health care costs and access to care are always enormous and frequently debated. These issues are high on the list of policy discussions at every level of government and throughout the private sector, whether it is a discussion of how to: improve access to health care; control prescription drug costs; structure employee benefit plans; to keep citizens, employees, and families healthy and productive. Legislative consideration of the issues and programs that relate in any way to the cost of health care is a small piece of the overall debate. Controlling health care costs will require a larger, more encompassing, solution. The executive and legislature can seemingly only chip away at health care issues until a more global solution is found.

**Fiscal
Challenge**

Correctional offender population continues to grow. From FY 2000 through FY 2006, the number of offenders in secure custody, community placement, and under community supervision increased from 8,854 to 11,718, an average annual growth of 4.8 percent. The Department of Corrections projects that all segments of the correctional system will grow in the 2009 biennium, with overall population increasing from 11,718 in FY 2006 to 14,571 in FY 2009, or 7.5 percent per year in FY 2008 and 2009. Controlling expenditures in this area of the budget requires legislators to look at sentencing criteria, how court actions and alternatives impact the population, how to prevent individuals from entering the correctional system or returning to the system, as well as the costs and benefits of various treatment and incarceration alternatives.

Legislative Action: General fund expenditures for the 2009 biennium increase \$105.6 million, including pay plan and retirement costs. This represents 43.9 percent increase over the previous biennium. The legislature budgeted for a population growth of 6.1 percent in FY 2008 and 6.3 percent in FY 2009, or from 11,718 in FY 2006 to 14,205 in FY 2009.

Issue: The legislature continued to emphasize community and treatment alternatives as opposed to secure beds and a belief that its investment in these types of programs would decrease recidivism and growth in the correctional system. This was among the rationale considered by the legislature in providing funding that supports a lower level of "average daily population" growth than requested in the executive budget and projected by the department.

One factor that will add to population growth is the passage and approval of SB 547, commonly known as Montana's "Jessica's law". The department anticipates this will add 32 offenders a year to the correctional system. Over the course of 25 years, compounded annually, this is a total of 800 offenders added to the correctional system.

**Fiscal
Challenge**

Higher education has been funded to a greater and greater extent in recent biennia with increased tuition charges to students, as general fund has become a smaller share of total funding. The legislature will need to reconcile the difference between what the total state funded share of higher education should be, and what the state can afford. In addition, the legislature needs to determine how to make the accountability measures (developed by the Postsecondary Education Policy and Budget Subcommittee (PEPB)) operational with the university system budget.

Legislative Action: The 2009 biennium budget approved by the legislature in HB 2 included \$25.6 million general fund to support the College Affordability Plan (CAP) to freeze student tuition at their current level for academic years 2008 and 2009. While the Board of Regents has agreed that this level of funding would be sufficient to maintain tuition with no increases, the legislature has no authority to enforce this agreement as the Regents have sole governance authority over the Montana University System, including the sole authority to set tuition rates.

The \$25.6 million funding level is based upon a negotiated agreement between the university system and state government as to the present law cost adjustment rates for the primary cost drivers in the university educational unit budgets. In addition to an agreement on the present law adjustment rates, the legislature agreed to fund these adjustments at an 85 percent state share level. The state percent share of funding in the prior biennium was approximately 42 percent. The 85 percent is based upon the ratio of Montana resident students plus regional exchange students to total student enrollment, as the remaining 15 percent is non-resident students.

Historically, the state percent share level of funding has been based upon the ratio of state funding as part of the overall revenue for the university units, which was approximately 39 percent in the FY 2006 base. Therefore, in the 2009 biennium budget the legislature has approved both a new fiscal formula for determining present law cost adjustments for the university system and a new mechanism to determine the state percent share of funding.

Issue: Given the split constitutional authority between the Board of Regents and the legislature, the CAP proposal by the executive would not be binding upon the university system specific to resident student tuition rates. At best, the CAP is a proposed agreement that would not have the force of law.

**Fiscal
Challenge**

State employee pay and benefits are likely to be a topic of debate for the 2007 session. State employees received a 3.5 percent increase in FY 2006 and a 4.0 percent increase in FY 2007, following a minimal increase in the previous biennium. State contributions to employee health insurance benefits attempt to keep pace with the growth in those costs, costs that continue to climb. Personal services costs are a large portion of the funding of state government and proposed increases warrant some scrutiny. At the same time, state government must be able to offer competitive compensation in order to recruit and retain a qualified workforce.

Legislative Action: The legislature approved the Governor's proposed pay plan in HB 13 which includes a 3 percent per year increase in state employee salaries (provided as of October of each year), and adjustments to the state share of health insurance cost of \$396 and \$432 in calendar years 2008 and 2009, respectively. The pay plan bill also includes a "flexibility component" (0.6 percent) intended to allow agencies to provide salary adjustments for such things as progression, competencies, and performance, and an increased longevity increment (1.5 percent to 2 percent) for employees that have worked 10 years. In addition, HB 13 provides for making the already partially implemented "broadband pay system" the state's primary compensation system. The estimated cost of the proposal is \$58.6 million general fund and \$42.2 million other funds over the biennium.

Issue: One of the primary goals of a conversion to a broadband pay plan is to improve recruitment and retention of employees. Generally, changes in salary for these purposes have taken place outside of the pay plans reviewed and approved by the legislature, and are built into statewide present law adjustments. Consequently, these changes are not transparent to the legislature, and the legislatively reviewed pay plan becomes a smaller part of the factors that cause adjustments in salaries. In the future, with the full implementation of the broadband plan, the legislature may want to review any proposed pay plan within that context, and provide more guidance on the implementation of the alternative pay plan, including establishing measures for gauging success in addressing recruitment and retention. Efforts during the regular session to provide some "side rails" to broadband pay plans were cut short by a transmittal deadline.

**Fiscal
Challenge**

The financial condition of **public employee retirement funds** remains a significant issue among the challenges facing the legislature. The state constitution requires that public retirement funds be actuarially sound and state law provides that contributions to the plans be sufficient enough to amortize the unfunded actuarial accrued liability (UAAL) over 30 years. The investment losses of the 2001-2002 recession accompanied by the approval of unfunded benefit enhancements, have yet to be recovered in full. In spite of an infusion of \$125 million by the legislature and some changes in investment strategies intended to at least stabilize investment returns, four of the public pension plans still have UAAL's that cannot be amortized over a 30-year period. The picture has improved, but the total unfunded liability of the four plans is reported at \$1.3 billion, of which \$581 million is needed to satisfy the amortization requirement.

Legislative Action: The legislature, in HB 63, approved: 1) a \$50 million cash infusion to the Teachers' Retirement System (TRS); 2) a phase-in of higher employer contribution rates for TRS, funded by state funds to avoid property tax increases; and 3) closing loopholes in the TRS benefits calculations. In HB 131, the legislature approved: 1) reducing the guaranteed annual benefit adjustment for new hires in the Public Employees' Retirement System (PERS), the Sheriffs' Retirement System, and the Game Warden and Peace Officers' Retirement System (GWPORS) from 3 percent to 1.5 percent; and 2) increasing employer contribution rates for PERS and SRS to actuarially fund the remaining liability down to being amortized within the 30 year period. Although these actions go a long ways toward solving the unfunded liability problem, they do not completely satisfy the constitutional and statutory criteria. The resulting amortization period for TRS is 33.2 years, for PERS is 30.2 years, and for SRS is 30.6 years. It can be argued that, at least for PERS and SRS, the criteria are very close to satisfied.

Issue: Future actuarial valuations will determine the potential impact of these changes as the retirement plans depend upon how actuarial assumptions into the future play out. From another

perspective, legislators need to understand that there are long-term on-going costs that will become part of base budgets for many years to come. Regardless, retirement boards, plan administrators, and legislators will need to be vigilant in maintaining the soundness of these plans. The health of these various plans will continue to be a challenge in light of the volatility of investments and the changing demographics that make up the actuarial assumptions.

Fiscal Challenge

Management of capital assets is an important function of state government. A key component is the **maintenance of state facilities** and other assets. The deferral of such maintenance has been a long-standing issue, made worse by the budget shortfalls of recent years. Delaying maintenance activities can result in higher future costs as facilities deteriorate beyond the need for ordinary repairs and replacements.

Legislative Action: In the 2009 biennium, the legislature showed a greater commitment to state building maintenance and construction by including one-time general fund transfers (OTO) of \$126.1 million to the capital projects account. With OTO funds, the legislature addressed some of the critical need for deferred maintenance in the state complex. HB 4, passed in the May 2007 special session, included numerous appropriations designed to reduce the deferred maintenance backlog, estimated at over \$200 million, by between \$40 million and \$65 million. However, the Sixtieth Legislature did not address the ongoing problem of inadequate capital maintenance funding. If the issue of inadequate capital maintenance funding is not addressed, the resulting deferred maintenance backlog will continue to increase.

Issue: The issue of the major maintenance funding inadequacy and the growing deferred maintenance backlog has generated the concern of both the executive and the legislature, and both have developed ideas on how best to attack the problem.

Fiscal Challenge

Legislation known as the Montana Public Defender Act (SB 146), enacted by the 2005 Legislature, created a **statewide public defender system**. This new statewide system became operational beginning July 1, 2006 (FY 2007). The new system is charged with providing public defender services in all courts in this state and is administered by the Office of Public Defender (OPD). This new function has reported funding shortfalls for FY 2007 and is expected to request a supplemental appropriation of about \$3.3 million.

Legislative Action: The legislature approved appropriations of \$19.8 million total funds for FY 2008 and \$20.2 million total funds for FY 2009. For FY 2007, the legislature also approved a supplemental appropriation that ended up being \$5.4 million.

Issue: The 2009 biennium funding of \$19.8 million for FY 2008 and \$20.2 million for FY 2009 is significantly greater than the \$14.1 million appropriated by the legislature for FY 2007, the first year of operation for the new system. Lack of detailed data supporting estimates, historical expenditure patterns, and caseload data made it difficult to determine what factors drive the costs and thus, what level of funding is necessary to support the system the legislature envisioned. This lack of data also makes it difficult to identify potential policy decisions or changes to this new system that the legislature might find desirable. FY 2008 is anticipated to be the first full year of implementation of the new system. Thus when the legislature convenes in FY 2009, it will have only one year of data for the fully implemented system.

**Fiscal
Challenge**

Pending litigation and subsequent court rulings can impact state finances. The school finance litigation lawsuit outcomes are still under scrutiny. Currently, there are three lawsuits related to workers' compensation claims that could have significant general fund consequences. Another lawsuit is challenging requirements for dam owner to make lease payments on navigable stretches of Montana rivers. And finally, there is a suit protesting state property taxes of a state power company.

Legislative Action: With the possible exception of school funding decisions, legislative actions were not taken relative to pending legislation. One of the workers' compensation cases was settled but impact is relatively minor. Other potential outcomes are still pending. As for the school funding litigation, whether or not the actions of the legislature have an effect remains to be seen. The legislature provided a significant increase to schools, \$186 million in general fund in the 2009 biennium over the 2007 biennium, a 16.25 percent increase.

Issue: The legislature simply needs to be aware of the potential cost or revenue implications of the array of litigation in which the state is a party. While the outcomes are unknown at this time, each of these lawsuits has the potential of significant impact to state revenues or expenditures.

**Fiscal
Challenge**

Supplemental emergency appropriations for the next biennium have not in the past been budgeted by the legislature and not accounted for in the ending fund balance. The state continues to experience supplemental appropriations each biennium, particularly for fire suppression. The state share of fire costs for 2007 biennium surpassed \$36 million. For any future biennium, the legislature needs to keep in mind that supplemental appropriation requests are common, with general fund supplemental appropriations varying from \$11.5 million to \$82.2 million over the previous 10 biennia.

Legislative Action: Supplemental appropriations for FY 2007 approved by the 2007 Legislature total \$83.3 million general fund and \$375,000 state special revenue. Some discussions during the special session regarding the 2009 biennium budget raised expectations of supplemental appropriations for FY 2009, implying that there are already areas of the 2009 biennium budget that are under-funded.

Issue: Typically, the potential for supplemental appropriations is considered a component of the fund balance reserve, but has not been specifically identified in the balance sheet. This speaks to the need for an adequate reserve, which is discussed later, or the need to anticipate supplemental appropriations in the balance sheet as a separate item.

**Fiscal
Challenge**

Potential **loss of federal funds** as a source of funding for many state and federal programs is a concern because of the large federal deficit and the administration's goal of cutting the deficit in half by 2008. The loss of federal funds translates to either reductions in services to citizens or increased state costs to offset the loss, loss of jobs in the state, and loss of "imported" money into the Montana economy.

Legislative Action: The legislative budget (HB 2 of the special session) includes \$3.4 billion in federal funds for the 2009 biennium, a \$291.4 million, 9.3 percent increase over the 2007 biennium (actual 2006 and budgeted 2007). This includes some replacement of federal funds with general fund.

Issue: The Montana budget has an increasing reliance on federal funds, as federal funds comprise 42.9 percent of the total proposed HB 2 budget. A significant federal cutback could have a devastating impact on government services in Montana and/or the state budget.

Fiscal Challenge

Long-term stability of the general fund becomes an issue when changing demographics become a big player in the demand for government services or are an influencing factor in the generation of state revenue. Emerging examples of potential instability are: 1) the aging population of Montana as well as other states; 2) the tenuous nature of components of some key revenue sources; 3) the pending litigation mentioned above; and 4) the federal funds reliance issue discussed above.

Legislative Action: The legislative budget, for the most part, deals with the upcoming biennium budget (2009 biennium) and does not address the revenues and expenditures beyond those years, or beyond the short-term calculation of structural balance. The legislative budget does, as did the executive budget, flag a large number and amount of expenditures in this budget as one-time-only, meaning that they will be removed from the base for the 2011 biennium budget. The legislature ended the special session with a \$183.8 million fund balance. The executive had recommended a \$100 million ending fund balance reserve and the establishment of a “Big Sky Savings Account” or rainy day fund as a buffer for future uncertainty and long-term instability, but the bill (SB 137) developed by the interim Legislative Finance Committee in concert with the executive was not passed by the legislature.

Issue: The legislature needs to be aware of potential future impacts as it considers the many proposals it will face in the upcoming session. An in-depth assessment of the long-term sustainability of the general fund may be a prudent consideration.

Fiscal Challenge

Economic development is a high priority of the administration. At various time over the years, legislatures have invested in numerous economic development efforts but have historically had difficulty seeing results, as results are frequently difficult to measure. The challenge for the legislature is to make the funding of economic development agencies and programs contingent on agencies providing measurable goals and objectives for such efforts and being able to document the outcomes and prove the value of the investment.

Legislative Action: The 2007 Legislature funded several economic development programs that were funded by the 2005 Legislature as one-time-only appropriations and invested state funds in new economic development programs. The 2007 Legislature approved the Governor’s budget request for funding the New Worker Training Grant Program (\$8.0 million general fund), the Tribal Economic Development Grant Program (\$1.6 million general fund), the Main Street Program (\$0.2 million fund switch from state special revenue to general fund), and the Made in Montana Program (\$0.2 million general fund). The legislature also funded the Montana Capital Investment Board that was created by the 2005 Legislature but not funded. The legislature approved a \$2.0 million general fund investment in

biomedical research and \$0.7 million general fund investment for a new initiative to promote and develop energy infrastructure in Montana.

Issue: As is true for many economic development efforts, there needs to be accountability for the investment that is committed to a project. Measurable goals and objectives, and related accountability measures, are critical in determining the effectiveness of these efforts.

**Fiscal
Challenge**

Controlled budget growth (structural balance) will continue to be a concern, regardless of the sizable projected fund balance expected for the end of the 2007 biennium, with more moderate revenue growth anticipated through the 2009 biennium. The challenge for the legislature is to resist the temptation of spending a large fund balance on on-going obligations and to not spend more in a biennium on on-going programs than is available from on-going revenues. A fund balance, in excess of projected revenues and a prudent reserve, should be considered one-time revenue just by its very nature of being unexpected revenues.

Legislative Action: The legislature passed a budget that is structurally balanced and, as analyzed, meets the challenge presented above. The longer term issue of sustainability is discussed in a previous challenge.

Issue: The legislature needs to keep the bigger fiscal picture in mind as it considers future budget proposals.

**Fiscal
Challenge**

Adequacy of the **ending fund balance reserve** will need to be monitored by the legislature as the session progresses. What will it take to ensure that Montana keeps an adequate “safety net” in place?

Legislative Action: The legislature ended the special session with a general fund ending fund balance of \$183.8 million, which represents a 5.1 percent reserve. This exceeds the proposed \$100 million reserve by a difference that the Governor has characterized as the “Big Sky Savings Account” that he proposed in the executive budget, but for which legislation failed that would provide statutory authority and structure.

Issue: While the available funds are well above the recommended minimum fund balance, the question is: “How much is enough?” National experts consider a 3 percent reserve to be a minimum (about \$110 million). The legislative budget exceeds that amount. Still, Montana is one of only a few states without a “rainy day fund”, as was proposed by a bill jointly offered by the Legislative Finance Committee and the administration, a bill that passed out of the Senate but died in the House Appropriations Committee.

**Fiscal
Challenge**

Economic uncertainties can undermine revenue-forecasting efforts, and contribute to an increased demand for government services in areas such as human services and corrections. As in any legislative session, there are many unknowns surrounding revenue forecasts. Capital gains income, corporate profitability, and oil and gas price and production could all fluctuate significantly. Assumptions used in the revenue forecasting process are based upon the best information available, but what might happen to change those assumptions?

Legislative Action: The legislature approved a budget that leaves a \$183.8 million ending fund balance as a reserve.

Issue: Regardless of the sizable fund balance, revenues can be fragile as was experienced in 2002 and 2003, when revenue shortfalls were easily greater than the projected 2009 biennium ending fund balance.

**Fiscal
Challenge**

General fund spending without HB 2 appropriations occurs in general fund non-budget transfers and through statutory appropriations. Authority for such spending is authorized in statute, but doesn't receive the usual scrutiny that HB 2 appropriations require. The challenge in this case is for the legislature to minimize the occurrence of spending that does not require regular scrutiny by the legislature.

Legislative Action: The legislative budget includes some rather significant increases in statutory appropriations and transfers. Statutory appropriations for the 2009 biennium are estimated to be \$432.1 million general fund and transfers are estimated to be \$230.2 million. However, the increases are, for the most part, one-time-only in nature and would not continue into the next biennium without legislative action. For example, the 2009 biennium statutory appropriations include \$98.4 million that will be returned to taxpayers in the form of a \$400 per household rebate. As for transfers, a \$179.9 million transfer of general fund to the long-range building account and a \$25 million transfer to the water adjudication account make up most of the increase.

Issue: The legislature has, over the years, established numerous statutory appropriations and transfers in statute, expenditures that do not receive the same scrutiny or prioritization as HB 2 appropriations. Legislators need to be aware that these types of disbursements exist outside HB 2.